

February 20, 2015

Via Electronic Upload to BIS Server

Secretariat for the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Re: Fundamental review of the trading book: outstanding issues

Ladies and Gentlemen:

The Goldman Sachs Group, Inc. ("Goldman Sachs") welcomes the opportunity to comment on the Basel Committee on Banking Supervision ("Basel Committee") Consultative Document entitled "Fundamental review of the trading book: outstanding issues" ("FRTB" or the "Framework").

Goldman Sachs has participated in the preparation of the comment letter written by IIF, ISDA and GFMA (the "Industry Letter"), and we support its comments and recommendations¹. Due to our concerns with the direction of the FRTB and with the systemic implications of some of the issues, we are supplementing that letter with our own.

We support capital requirements for the trading book that are appropriately risk-sensitive and less prone to inconsistency of application across different jurisdictions. We believe that risk-based allocation of capital plays an important role in driving global economic growth. However,

¹ Institute of International Finance (IIF), International Swaps and Derivatives Association, Inc. (ISDA) and the Global Financial Markets Association (GFMA). "Industry Response to the BCBS Consultative Paper on the Outstanding Issues with regards to the Fundamental Review of the Trading Book (FRTB) capital standards – BCBS 305, published on December 2014", dated 20 February 2015.

we have serious concerns that, by setting year-end 2015 as the deadline for finalizing a new Framework², the Basel Committee will leave insufficient time to carry out suitably rigorous Quantitative Impact Studies (QIS), evaluate the results and macro-economic consequences, and incorporate any necessary amendments in the final guidelines. We therefore have three recommendations:

1. The Basel Committee should plan further rounds of targeted impact studies and should allow sufficient time for their completion. The FRTB represents a complete overhaul of the capital requirements for the trading book, requiring firms to make fundamental changes to their systems architecture, calculation methodologies and data feeds in order to calculate its impact properly. Moreover the Framework continues to evolve rapidly, requiring both further systems changes and sufficient time to resolve issues of interpretation arising from these revisions. Until such changes are ready, firms need to make broad assumptions and interpretations that will likely lead to a wide range of capital estimates in the QIS now underway (QIS3). In our opinion, the amount of time allotted to the only other full-portfolio QIS³ was insufficient, and it is not clear to what extent its results have informed the current design. There is a danger that the final design is decided on the basis of only two full-portfolio QIS results, both of which may be based on simplifying assumptions and inconsistent interpretations across firms and across jurisdictions.
2. We understand the Basel Committee intends to finalize the design of the Framework by year-end 2015 and potentially to devote the following two years to the calibration of the market risk rules. However, the design of the Framework cannot be finalized without calibration - in fact, the two go hand-in-hand. Due to the complexity of the FRTB, it is likely that design issues will come to light during QIS3 or in future QIS exercises, and it is essential that corrections be made to ensure the effectiveness of the Framework. We therefore recommend that the Committee continue working on both the design and calibration of the Framework throughout the period that was previously allotted for calibration alone (i.e. through year-end 2017). This will have clear benefits:

² In its paper "Reducing excessive variability in banks' regulatory capital ratios - A report to the G20", <http://www.bis.org/bcbs/publ/d298.pdf>, BCBS set out its goal of finalizing the trading book policy framework by year end 2015, in line with other policy initiatives such as a revised standardised approach and potential capital floors.

³ The prior QIS, calculated as of August 29, 2014, was submitted in October 2014.

- i. it will allow sufficient time to address the substantive issues raised in the Industry Letter, such as those related to securitizations and non-modellable risk factors;
 - ii. it will reduce the risk that the Framework creates perverse risk management incentives; and
 - iii. it will allow further targeted impact studies to be conducted, as recommended above.
3. Because an insufficiently tested Framework carries a high risk of capital mis-allocation and adverse impacts on market liquidity, testing must include a macroeconomic impact assessment. Although the Committee has repeatedly indicated that the goal of the FRTB is not necessarily to change the overall levels of capital requirements across the industry, it is very likely that significant increases and/or re-allocations of capital will occur across different market-making activities, in ways that could have a profound impact on markets. We provide one example for securitizations below, but emphasize the impact could be large for other product classes as well. If the capital requirements for individual activities are significantly out of line with underlying risk, there could be far-reaching implications for market liquidity, resulting in higher costs and fewer choices for end-users, and potentially greater systemic risk.
 - As an example, contrary to stated objectives, the Framework in its current form would require capital levels for securitizations far in excess of (in fact, sometimes multiples of) the maximum economic loss. Even for senior tranches of a securitization, the capital charges would be in excess of those for comparable debt and equity instruments. The result is likely to be sharply lower levels of inventory, decreased market liquidity and a higher liquidity premium demanded by end-investors. Consequently there will be upwards pressure on financing costs to underlying borrowers. The Basel Committee and other policymakers appear willing to encourage certain forms of securitization activity, and the currently proposed capital requirements would appear to run contrary to this objective⁴.

Taken together with the adverse impact on market-making activities of other policy initiatives, it is critical that the Basel Committee carry out a broader macroeconomic

⁴ For example, “Criteria for identifying simple, transparent and comparable securitizations”, <http://www.bis.org/bcbs/publ/d304.pdf>

impact study to understand the cumulative effect of these initiatives and their consistency with other policy objectives⁵.

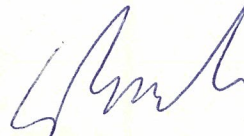
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In closing, we would like to reiterate our support of the efforts of the Committee with respect to the Framework. The risk-sensitive allocation of capital plays an important role in allowing capital markets to drive growth in the global economy. Reflecting the importance of allocating capital to business activities in a manner that is commensurate with risk, we believe it is critically important to extend the timeline in order to allow for robust QIS data to be sufficiently evaluated and incorporated into the Framework. Further, we encourage the Committee to ensure that a macro-economic study is completed before any Framework is finalized. We recognize that this is a challenging exercise, and would be pleased to assist in any way helpful.

Sincerely,



Craig Broderick
Chief Risk Officer

cc.

Mr. Lance Auer, Federal Reserve Bank of New York

Mr. Dan Sullivan, Federal Reserve Bank of New York

Mr. Greg Gaare, Federal Deposit Insurance Corporation

Mr. Michael Gibson, Federal Reserve System

Mr. Terrence McCarthy, Federal Deposit Insurance Corporation

Ms. Ann Cathcart, New York State Banking Department of Financial Services

Mr. Andrew Bailey, Prudential Regulatory Authority

Mr. Masamichi Kono, Financial Services Authority

⁵ For example, the Committee on the Global Financial System's paper on market liquidity, <http://www.bis.org/publ/cgfs52.htm> states: "Market-makers serve a crucial role in financial markets by providing liquidity to facilitate market efficiency and functioning...Several supporting initiatives, such as strengthening liquidity risk management, improving market transparency and monitoring or adjusting incentive schemes for market-makers, would help making this outcome more likely and would support the robustness of market liquidity".